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No. 10

IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

THE UNITED STATES OF AMERICA, *Petitioner*,

v.

OLYMPIC RADIO AND TELEVISION, INC., *Respondent*

On Writ of Certiorari to the United States Court of Claims

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The original Opinion of the Court of Claims together with the dissenting opinion (R. 10-14) is reported in 108 F. Supp. 109. The supplemental Opinion with dissent (R. 16-19) is reported in 110 F. Supp. 600.

JURISDICTION

The Court of Claims' judgment was entered November 4, 1952 (R. 10, 14). The Government filed a motion for rehearing on December 3, 1952 (R. 14) which was denied in the supplemental Opinion decided March 3, 1953 (R. 16). On May 29, 1953, the Government filed a petition for

writ of certiorari which was allowed October 14, 1954 (R. 21). The Court's jurisdiction of this controversy is founded on 28 U. S. C., Section 1255(1).

QUESTION PRESENTED

In 1946, the taxpayer's deductions exceeded its gross income by $310,872.60. It paid the Collector of Internal Revenue $263,272.80 in excess profits taxes within the year 1946. Taxpayer added the latter amount to the $310,872.60 under Section 122(d)(6) of the Internal Revenue Code[1] and carried-back the aggregate of $574,145.40 to the year 1944 as a net operating loss deduction[2] in the latter year. Section 122(d)(6) required the addition of excess profits taxes "paid or accrued"[3] within 1946 to the excess of deductions over gross income in that year in determining the amount of the 1946 net operating loss. The question is: Should the taxpayer be denied the right to take into account excess profits taxes *paid* in 1946 in computing the amount of the 1946 net operating loss under Section 122 (d)(6) because: (a) it used the accrual method of accounting or because, (b) the taxpayer happened to incur a net operating loss in 1947 which, when carried back to 1945, resulted in refunds or credits to the taxpayer of the excess profits taxes for the year 1945 paid in 1946.

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[1] Unless otherwise noted references to the "Code" or the "Internal Revenue Code" relate to the "Internal Revenue Code of 1939".

[2] There is no dispute as to the carry-back of the $310,872.60. and its allowance as a deduction in 1944; credits or refunds of a portion of the 1944 taxes were made as a result of the allowance of such a deduction. The dispute relates only to the tax effect of the additional amount of $263,270.80 included by the taxpayer in the gross amount of net operating loss claimed under Section 122 (d) (6). If allowed, the net operating loss carry-back and finally the deduction will be increased *pro tanto*.

[3] In this proceeding there is only a "paid" issue; there is no present issue involving taxes "accrued". See R. 5.

STATUTES INVOLVED

Pertinent Code Provisions are printed in full in Appendix A, pp. 47 to 60.

Provisions of certain Revenue Acts and prior Code provisions are also printed in Appendix A.

STATEMENT

This Federal tax refund suit was submitted to the Court of Claims on motions for summary judgment together with supporting affidavits filed by both parties. The undisputed facts are briefly as follows:

The taxpayer, a corporation chartered in New York State and engaged in the manufacture of radio and television receiving sets, kept its books and accounts on the accrual basis and filed its Federal corporation tax returns on the same basis, using a calendar year (R. 1, 3).

The taxpayer's Federal corporation income tax return filed for the year 1946 disclosed no tax liability, reflecting instead a net operating loss of $324,844.23. Subsequent audit of this return by the Bureau of Internal Revenue reduced this loss to $310,872.60 to which the taxpayer agreed. (R. 2, 3, 11)

As provided by statute, the loss of $310,872.60 was carried back to the year 1944 where, allowed as a net operating loss deduction in that year, it produced overpayments of tax which were credited or refunded to the taxpayer (R. 5, 11).

In the year 1946 taxpayer had paid $263,272.80 in excess profits taxes with respect to its excess profits tax liability for the year 1945 (R. 2, 9). In June, 1948, taxpayer filed a claim for refund of additional income and excess profits taxes for the year 1944 based upon the provisions of Section 122(d)(6) of the Internal Revenue Code. That claim was predicated on the contention that the taxpayer was entitled to include the sum of excess profits taxes actually paid within 1946 in determining the amount of net operat-

ing loss for 1946 and the corresponding deduction in 1944. (R. 2, 3, 11)

Failure of the Commissioner of Internal Revenue to take action with respect to said refund claim for more than six months after the filing thereof authorized the taxpayer to file petition in the United States Court of Claims on June 14, 1952 (R. 1-3). In that Court, the taxpayer abandoned some of its contentions[4] and sued for a refund of $148,841.72[5] in excess profits tax for 1944 with interest as provided by law. (R. 5, 10,14)

The Court of Claims held for the taxpayer and found that it was entitled to include the amount of excess profits taxes paid in 1946 in computing the amount of its 1946 net operating loss under the provisions of Section 122(d)(6) of the Internal Revenue Code (R. 10-14.) In so holding the Court ruled that "paid or accrued" used in that Section must be construed as permitting a deduction for excess profits taxes paid even though the taxpayer used the accrual basis. (R. 12-13, 16) The majority of the Court of Claims (with two dissents) found that this construction of Section 122(d)(6) was in accord with the clear intention of Congress (R. 10-14). On rehearing the same majority of the Court of Claims (with the same dissents) adhered to its original decision (R. 16-19).

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[4] The abandoned contention related to an argument that $86,333.74 of excess profits tax accrued in the year 1946, arising out of the settlement of a dispute by agreement to a deficiency in excess profits tax in that amount. (R. 5, 7)

[5] This amount was based upon a "paid" theory only and is the amount stated in the petition to the Court of Claims. Actually, that amount is less than the proper amount refundable to the taxpayer on the basis of the holding by the Court of Claims. Due to an inadvertent error in the arithmetic computation of the effect of the additional deduction in 1944 the amount recoverable was understated in the petition. As recomputed by the taxpayer, the proper result in 1944 is an overpayment of excess profits tax of $116,425.80 and an overpayment of income tax of $53,729.41, or an aggregate overpayment of $170,155.21.

SUMMARY OF ARGUMENT

How should "paid or accrued" formerly appearing in Section 122(d)(6) of the Code be construed? Did the words connote accounting methods? Or did they refer to tax transactions, namely, actual tax payment, or that a liability for tax had arisen?

I

As a first method the taxpayer takes a practical approach, letting the results under the opposing theories point the way to the legislative purpose and proper construction. The taxpayer construes "paid or accrued" to refer to transactions involving either payment or the arise of a liability while the Government construes the words to refer to accounting methods. Under the Government's construction, of course, "paid" relates to a cash basis taxpayer and "accrued" relates to an accrual basis taxpayer.

Excess profits tax liabilities for 1945 were conventionally paid during the following year regardless of accounting methods. If 1945 was a profit year and was followed by a loss year then excess profits taxes would be paid in a loss year. Taxpayer regards this as the situation envisaged by Section 122(d)(6); it would apply to any taxpayer regardless of accounting methods. This is the ordinary case.

Unlike this equitable result the Government's construction results in gross discrimination against the bulk of corporate taxpayers who report on the accrual basis and favors the comparatively few cash basis taxpayers. If "paid" is confined to a method of accounting then obviously the cash basis taxpayer could pay its tax in a loss year. Conversely, an accrual basis taxpayer under identical circumstances would derive no benefit as its taxes would have accrued in the prior (tax) year and payment would be meaningless. Nor could the accrual basis taxpayer accrue an excess profits tax liability for the loss year itself. As a practical matter it was impossible to have a net operating loss under Chapter 1 (income tax) and at the same

time have an excess profits tax liability under Chapter 2. The unusual type of situation was one where a tax deficiency was contested postponing accrual and settlement occurred in a loss year. Under those circumstances an excess profits tax liability could accrue in a loss year under either party's theory. This, however, it must be emphasized was an unusual type of situation of limited applicability whereas the payment situation was ordinary for all taxpayers.

The Court below and even the Second Circuit have recognized the inequitable situation inherent in the Government's argument. This type of inequity is to be distinguished from the ordinary differences found between taxpayers arising from different accounting methods. Those disadvantages were temporary while the discrimination here was permanent. Recalling that the net operating loss provisions were essentially relief provisions designed to help taxpayers by permitting them to spread losses, it is inconceivable that Congress in that process deliberately intended to discriminate against the great bulk of corporate taxpayers in an ordinary situation. Congress must be presumed to have intended "equality among taxpayers", and only the taxpayer's transactional concept achieves such a result.

II

Congress did not define the words "paid or accrued" when used in Section 122(d)(6). The meaning of these words, however, may be gleaned by analyzing the provisions of the statute themselves, by analyzing the legislative history to determine legislative intent, and finally on the authority of a related line of cases. The foregoing sources lead to the conclusion that Section 122(d)(6) was designed to permit corporate taxpayers regardless of accounting methods to take as a deduction the amount of excess profits tax paid in a loss year in determining the amount of the net operating loss.

Of all the adjustments under Section 122(d), the (6) adjustment, the one here involved, was the only one intended to help a taxpayer where a net operating loss had been incurred. All of the others tended to reduce the amount of the loss. The (6) adjustment was the "addition" referred to in the caption of Section 122(d) as it "added to" the amount of the loss.

Although Congress used the word "deduction" in Section 122(d)(6) it is clear that the word as used there was not used in a conventional sense, as under Section 23, for example. Section 23(c)(1)(B) of the Code specifically made excess profits taxes non-deductible in determining net income in 1946. This provision had been added by the same section of the Revenue Act of 1942 which added 122(d)(6) to the Code.

Taxpayer concludes, therefore, that as a conventional deduction was not intended, Congress must have designed the adjustment to permit the "addition" of excess profits taxes either paid or accrued in the loss year to the amount of the net operating loss just as if they had been deductions for this limited purpose. This renders the Government's argument on deduction wholly inapposite.

The technique used in Section 122(d)(6), while somewhat out of the ordinary, was similar to a technique used by Congress in a number of other Code provisions in effect at the same time. The other Code provisions were those relating to foreign personal holding companies, domestic personal holding companies, improper accumulations of surplus and even the excess profits tax itself. Each of these "super-surtaxes" plugging loopholes was levied upon a tax base derived from but different from net income. Conventionally, a number of adjustments were made, differing among the various sections, to convert net income to the respective tax base concerned in each of the differing sections. In both of the personal holding company sections as well as the one involving improper accumulations of surplus, otherwise non-deductible Federal taxes were re-

quired to reduce net income under language which in each case described such taxes as "paid or accrued during the taxable year". Those cases construing these provisions such as *Commissioner* v. *Clarion Oil Company,* 148 F. (2d) 671, in the case of personal holding companies, have uniformly held that "paid or accrued" referred to transactions and not accounting methods. In each case the rationale was that accounting methods were connoted by paid or accrued under Section 48(c) only where net income was involved. Adjustments made to net income after it had been determined were not controlled by these terms which were to receive their ordinary meaning.

The parallel between these types of adjustments and that involved under 122(d)(6) is striking. In the situation here involved net loss (excess of deductions over gross income or negative net income) was to be adjusted for the "exceptions, additions and limitations" of subsection 122(d). These adjustments converted "net loss" into net operating loss. The (d)(6) adjustment, a negative type of factor, tended to increase a net loss or reduce net income. Though not a base for imposing tax it was a base for a refund of tax. The identity of language and structure used in the two situations require the conclusion that what Congress intended in the other situations it must have intended here as well.

In spite of the Government's implication that Congress "overlooked" many things in connection with Section 122(d)(6) and that, therefore, this Court should legislate what was overlooked and deny the benefit of that section to accrual basis taxpayers, it is demonstrable that Congress devoted close and detailed attention to the section. It is also clear that duplication of benefit was deliberately prevented.

Among the examples of Congressional interest in the section are:

(a) The three qualifying Rules under (d)(6) applying to widely diverse situations.

(b) The fact that a Section 26(e) credit never appeared under Section 122 where a (d)(6) adjustment was allowed. The Section 26(e) credit against net income was one allowed in the amount of income subject to excess profits tax.

(c) Adjustments under Section 122(b) involving the (d)(6) factor were in harmony with the Congressional concept that the payment of such tax was an economic loss.

(d) Sections 711(a)(1)(J) and (a)(2)(L) were restrictive provisions confining the operation of Section 122(d)(6). They indicated a Congressional consideration of the very question of double benefit and deliberately prevented it. It would be unwarranted to go beyond the limitation imposed by Congress itself without express authority.

(e) Section 26(c)(2), while incorporating the (d)(1), (2) and (3) adjustments carefully omitted the (d)(6) adjustment in a section of very narrow technical application.

It would be unreasonable to suppose that Congress drafted these complicated provisions to achieve nothing. For if paid or accrued were given the meaning the Government urges, that meaning inevitably would emasculate the section. Could Congress intend such a result?

A line of cases starting with *Commissioner* v. *Clarion Oil Co., supra*, has repeatedly held in the personal holding company context that "paid or accrued" need not necessarily refer to accounting methods as required by Section 48(e) and that where some statutory concept beyond net income was involved "paid or accrued" may receive their ordinary transactional meaning with reference to tax payments or tax accruals. This line of cases, therefore, distinguished those cases dealing with ordinary tax deductions from net income as inapposite. Three Circuit Courts, the Court of Claims, a District Court, and the Tax Court of the United States have all followed the *Clarion Oil* principle. It has recently been extended into the analogous situation

of Section 102 where a construction similar to *Clarion Oil Co.* was given. Whether personal holding company surtax or improper accumulations of surplus were involved, these similar type of adjustments, just like the (d)(6) adjustment, helped taxpayers by reducing the base for the surtax.

The legislative history of Section 122(d)(6) and related provisions reveals that paid or accrued were intended to refer to transactions and not accounting methods. Two significant omissions under Section 122(d)(6) enacted by the Revenue Act of 1942, bear this out. The two omissions were, respectively, Rule (A), formerly appearing under Section 23(c)(2) and the absence of the Section 26(e) credit.

The 1941 Revenue Act allowed excess profits taxes as a deduction in computing net income (Code Section 23(c)(2)). That allowance was qualified by four rules, the first of which placed cash basis taxpayers on the same basis as accrual basis taxpayers by considering taxes paid after a taxable year as though paid within the taxable year. When Section 122(d)(6) was enacted by the Revenue Act of 1942, Rules (B), (C) and (D) formerly under Section 23(c)(2) became Rules (A), (B) and (C) under (d)(6). Why was Rule (A) omitted?

The answer is that the rule would have been meaningless in a loss year. No tax liability could arise or be imposed in the loss year. Thus, the words "paid or accrued" could not have related to the loss year but must have related to transactions dealing with taxes of *prior* years. In any other context "paid or accrued" were inapposite.

The second omission, that relating to Section 26(e), occurred for the same reason and warrants the same conclusion. The same section of the Revenue Act of 1942 which enacted Section 122(d)(6) dealt also with credit for dividends received and computation of Section 102 net income. Each of these sections contained specific reference to the new 26(e) credit yet no reference was made

in Section 122(d)(6) with respect to that credit. Again the reason is attributable to the loss year. Where there was a loss there was no excess profits net income and hence no Section 26(e) credit. This omission likewise leads to the conclusion that "paid or accrued" related to prior year's taxes.

Committee reports indicate clearly that the purpose of the Section 122(d) adjustments, including (d)(6), was to sterilize net loss of non-economic factors and convert it into economic loss. Where the factors were used with a profit year (as in Section 122(b) or (c)) the effect was to convert net income into economic net income. These various adjustments at every stage of the computation from operating losses, through carry-back, to deduction made the connection between a (d)(6) adjustment and the final deduction very indirect. Moreover, the amount of the net operating loss deduction was derived from loss carry-overs and carry-backs from *other* years. Hence, Sections 43 and 48(e) did not apply as these items were not paid or accrued *in* the year of deduction.

In passing it should be noted that every attack made by the Government upon the taxpayer's contentions would, if valid, apply with equal vigor against a cash basis taxpayer in the identical situation and yet under the logic of the Government's theory a cash basis taxpayer who paid a tax in a loss year should benefit. Such inconsistency reveals the Government's real argument to be that it does not agree with the Congress and therefore Section 122(d)(6) should not apply to accrual basis taxpayers.

Even if it be held that "paid or accrued" technically and literally refers to methods of accounting as described in Section 48(e), then this Court should construe the quoted words in accordance with the Congressional intention already demonstrated. Where language is at odds with the purpose of the statute as demonstrated by an absurd or even unreasonable result arising from the words used, then this Court should follow the policy of the legislation as

a whole. Applying that rule here the transactional meaning should be given to paid or accrued under Section 122(d)(6).

III

The fortuitous occurrence of another loss in 1947 resulted in the taxpayer having a net operating loss carry-back to and deduction in 1945 thereby recovering for the taxpayer the excess profits taxes for that year paid in 1946. The Government cites this as showing that no economic loss resulted from the payment of tax in 1946.

This argument, also made below, was not even adverted to there.

The Government contends that only the tax as finally determined *after* carry-back was "imposed," and only the tax "imposed" could be an economic loss.

Aside from the fact that the payment of money undoubtedly was an economic loss the fact is that the original tax for 1945 was imposed. This is indicated by Section 56(a) of the Code and the rationale of *Manning* v. *Seeley Tube & Box Co., Inc.*, (1950) 338 U.S. 561.

That subsequent losses should not affect previously deducted taxes is also accepted by the Commissioner as indicated by two recent rulings.

The Government's argument tends to negative the annual accounting concept.

ARGUMENT

Introduction

The statutory provision the construction of which is in dispute is Section 122(d)(6)[6] of the Internal Revenue Code relating to net operating losses. To the extent here material that section provided:

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[6] This section of the Code has no present application. Enacted by the Revenue Act of 1942, it was never repealed but was simply made inapplicable with respect to any taxable years ending after June 30, 1950. See Section 304 (c) of the Excess Profits Tax Act of 1950.

> "There shall be allowed as a deduction the amount of tax imposed by subchapter E of Chapter 2[7] paid or accrued within the taxable year, * * *."

More specifically, the dispute centers about the words "paid or accrued." The problem is to determine the proper connotation of the quoted words when read in conjunction with Section 122(a) of the Code which defined the net operating loss to be:

> "* * * the excess of the deductions allowed by this Chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d)."

The taxpayer's position is that the words "paid or accrued" were disjunctives referring to tax transactions. The terms connoted respectively either the discharge of a liability for tax by payment or that a liability for tax had arisen.[8] These were the ordinary and usual meanings of these words. Inasmuch as the taxpayer actually "paid" or discharged its 1945 excess profits tax liability during the loss year 1946, it follows that under the statute the amount of such payment should be allowed as a deduction in computing the amount of net operating loss.

The Government reads the two words together and interprets "paid or accrued" to distinguish between taxpayers' methods of accounting. That is, "paid" refers to a payment if a taxpayer was on a cash receipts and disbursements basis and "accrued" refers to an accrual if a taxpayer was on the accrual basis. The Government argues that because the taxpayer was on the accrual basis it could not take into account the excess profits tax admittedly paid in 1946 because it had "accrued" in 1945.

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[7] Subchapter E of Chapter 2 related to excess profits tax.

[8] To distinguish the taxpayer's conceptual approach from that of the Government, the taxpayer's meanings may be regarded as "transactional" in nature while the Government adheres to an "accounting method" theory.

The taxpayer's position is supported in principle and reasoning by the language of the statute itself, by an analogous line of authority and is confirmed by the Congressional intent as manifested through the legislative history of the disputed section and related provisions.

I.

Only the Transactional Meaning of "Paid or Accrued" Permits Fair and Equal Treatment of All Corporate Taxpayers Regardless of Accounting Methods, as Intended by Congress

Before probing legislative history to discover Congressional intent, the nature of the problem suggests a practical approach; let the results under the opposing theories point the way to the legislative purpose and the proper construction. The taxpayer reads "paid or accrued" in the ordinary[9] or "transactional" sense while the Government construes "accounting methods." What are the practical effects of these opposed arguments? First the usual situation.

In the year 1945, every corporate[10] taxpayer was required to pay its excess profits tax in full on the fifteenth day of the third month following the close of its taxable year or in four quarterly installments during the year following the taxable year.[11] This was the usual or conventional way

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[9] In addition to the holding of the Court below on this point, a similar rule appears in a number of cases involving personal holding company situations. See *Commissioner* v. *Clarion Oil Co.* (CCA DC, 1945) 148 F. (2d) 671, 677; cert. den. 325 U. S. 881; *Birmingham et al., Exrs.* v. *The Loetscher Company* (CCA-8, 1951) 188 F. (2d) 78, 79; *Aramo-Stiftung* v. *Commissioner* (CCA-2, 1949) 172 F. (2d) 896, 897; *Wm. J. Lemp Brewing Co.* (1952) 18 T.C. 586, 600 and 601. The same rule also has been adopted in another situation, namely, improper accumulations of surplus arising under Chapter 1. See *Harry M. Stevens, Inc.* v. *Johnson* (DC SD NY, 1953) 115 F. Supp. 310, 312, (now pending before CCA-2).

[10] The excess profits tax imposed by Section 710 of the Code was levied only upon corporations.

[11] Sections 56 (a) and (b) of the Code.

in which corporate taxpayers liquidated tax return liabilities and this was so *regardless of accounting methods.*

Where a corporate taxpayer had a profit year in which it incurred an excess profits tax liability and the year following was a year of loss, then the excess profits tax liability for the profit year was routinely discharged by payment in the loss year. Under such circumstances, whether the taxpayer was on the cash or the accrual method of accounting, it met the requirements of Section 122(d)(6) under the taxpayer's theory. It had "paid" an excess profits tax within a loss year.

The "accounting method" sense the Government would place upon the words "paid or accrued," unlike this equitable result, produces a gross discrimination against the many accrual basis taxpayers and in favor of the few cash basis[12] taxpayers. A cash basis taxpayer, conventionally paying its liability for excess profits taxes in a loss year following a profit year, would obviously benefit under Section 122(d)(6). Its cash basis of accounting would recognize the payment as a "disbursement." In contrast, an accrual basis taxpayer *under identical circumstances* necessarily would be denied the benefit of the adjustment, under the Government's theory. For it, the taxes would have "accrued" in the year imposed and payment in the later year would have no effect under Section 122(d)(6).

Nor could the accrual basis taxpayer qualify under the Government's theory for an accrual in a loss year itself. To do so an accrual basis taxpayer would have had to incur an excess profits tax liability under Chapter 2 in a given year (based on taxable excess profits net income) and at the same time and for the same year incur a net operating loss (a negative net income figure) under Chapter 1. To state this is to indicate the answer. Ordinarily,

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[12] It is a commonly accepted truism that the great bulk of corporate taxpayers utilized the accrual method of accounting rather than the cash receipts and disbursements method.

therefore, it was obviously impossible to accrue both an excess profits tax liability and a net operating loss in the same year. The necessary result is that under the Government's theory the cash basis taxpayer could under ordinary circumstances qualify under Section 122(d)(6) while the much more significant class of corporate taxpayers—accrual basis—would automatically be disqualified. As to them, the benefits of the section would be "largely illusory." (See opinion below.)

There was also an unusual type of situation. Where liability for an additional (deficiency) tax was contested, such a contest would postpone the accrual of such a tax liability under well-recognized principles.[13] Termination of the dispute would fix the time of accrual and this could occur in a loss year.[14] Under such circumstances an excess profits tax liability "accrued" benefiting equally the cash or the accrual basis taxpayer under Section 122(d)(6).[15]

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[13] *Dixie Pine Products Co.* v. *Commissioner* (1944) 320 U. S. 516; at 519; *Security Flour Mills Co.* v. *Commissioner* (1944) 321 U. S. 281, 284-6.

[14] See *G.C.M. 25298*, 1947-2 Cum. Bull., 39, 43. Compare *Robert Reis & Co.* (1953) 20 T.C. 294, where an accrual basis taxpayer had a dispute as to deficiencies, there was a consequent postponement of accrual and finally *settlement and payment.* The latter two events both occurred in the loss year and both factors were cited by the Court. Under either party's theory here, the taxpayer should have prevailed in the *Reis* case.

[15] It must be emphasized again, however, that the accrual case was an *unusual* type of situation. It is described as unusual to distinguish it from the situation where taxes were paid on liabilities reflected on returns. The latter were the more usual and much more important category. Dollarwise, collections of additional taxes are not nearly as significant as tax collections based on return liabilities. For example, the *Annual Report of the Commissioner of Internal Revenue* for the fiscal year ending June 30, 1953 discloses on page 4 that corporate income and profits taxes collected for that fiscal year aggregated $21.6 *billions* (789,984 returns filed—p. 6). In the same fiscal year additional corporate income and profits taxes including interest and penalties assessed as a

This would be so under either theory. The Government cites this rare situation to show that its theory is not entirely inequitable. Note, however, that even this situation involved a discrimination favoring taxpayers with tax troubles over those without them.

The Court of Claims below recognized the force of the inequities inherent in the strained construction of the Government, particularly in the usual situation. Therefore, it rejected the Government's argument in favor of the taxpayer, convinced as it was of the intentions of Congress in this regard. (R. 12, 13.) Even the Second Circuit Court of Appeals in the companion case of *Lewyt Corporation* v. *Commissioner*, 215 F. (2d) 518 at 526, candidly recognized the force of this argument although it refused to act upon it.[16]

The inequitable and discriminatory results inherent in the Government's theory must be distinguished from that type of inevitable difference in tax effect occurring where,

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direct result of audit aggregated only $386 *millions* as shown on page 27 of the Report, or approximately 1.79 percent of the total (corporate returns examined totaled 110,996—p. 9). A similar Report for the fiscal year ending June 30, 1946 discloses total corporate tax collections of $7,822,488,154 on page 20 thereof. Additional assessments of corporate taxes for that year were not published but the taxpayer was advised by the office of the Commissioner of Internal Revenue on February 10, 1955 that additional corporate taxes assessed had aggregated $274,546,554 or less than 3 percent of the total. The conclusion seems inescapable that in comparison with total tax payments deficiency payments were comparatively very small. The Section 721 type of situation also cited by the Government was even rarer.

[16] The Second Circuit recognizing these equities, nevertheless, felt bound by the supposed mandate of Section 48 (c). That Section defined "paid or accrued" (where the computation of *net income* was involved) to refer to methods of accounting. As later demonstrated, Section 48 (c) does *not* control in the case of the Section 122 (d) (6) adjustment. Neither net income nor its negative equivalent (net loss) were directly involved; economic loss was the result of the adjustment.

due to accounting method used, a taxpayer was at a temporary disadvantage.[17] This is a situation where in the course of corporate operations losses were admittedly incurred. Congress in its plenary taxing power afforded relief[18] to taxpayers incurring losses by permitting them to spread the tax effect of such losses over adjacent years.[19] What the

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[17] The latter usually occurred in transition periods—for example when excess profits taxes were repealed in 1945 the accrual basis taxpayer was taxed on sales accruals not actually received until after repeal, while the cash basis taxpayer escaped high taxes on comparable income. The discrimination inherent in the Government's theory, on the other hand, always existed and always worked against the same class of taxpayer.

[18] In a very real sense Section 122 (d) (6) was a war relief measure. At the time the Revenue Act of 1942 was enacted many corporations not in war production were already experiencing declining profits and at the close of the war economy many other corporations were expected to experience declining profits. The provisions of Section 122 afforded in effect the same type of relief in periods of declining profits which the two-year carry-forward provisions afforded in periods of increasing profits. *5 Mertens, Law of Federal Income Taxation*, 1953 Ed., pp. 358-539.

During the war economy many normally deductible expenses were held down to a bare minimum by priorities, rationing, labor shortages and other factors beyond the control of the taxpayer. See Report No. 1631 of the Senate Finance Committee, 77th Cong., 2d Sess., p. 52. This situation was heightened by the operation of the excess profits tax law, which, because of the inability of taxpayers to take deductions for normal repairs and replacements would cause excessive net income which would be taxed as excess profits at a very high rate. *Mertens, Ibid.* See also *Diamond A Cattle Co.* (1953) 21 T.C. 1 at 7.

[19] The net operating loss deduction provision in taxing statutes and under the Code has had a checkered career. "In all its variations it has represented a response of Congress to the hardships caused by the taxable year as the measuring unit of time for determining tax liability, and in its inception in 1919 and its revival in 1939 was intended to favor taxpayers whose income was apt to fluctuate from year to year as well as those taxpayers whose business was in a period of development." *Mertens, Ibid.*, p. 355.

Government suggests was a deliberate Congressional intent to discriminate against the great bulk of corporate taxpayers in that process. It should require the most unequivocal expression of Congressional intent to justify a deviation from the ordinary meaning of "paid or accrued" to warrant such a position. A somewhat similar attempt by the Government to attribute to the Congress an intent to discriminate[20] against cash basis taxpayers was rejected in *Commissioner* v. *Clarion Oil Company*, 148 F. (2d) 671, where it was said (at p. 676):

> "Nor did Congress intend that the taxpayer on an accrual basis who entered in his books an arbitrary amount as a 'reserve for taxes' should be in a better position than the taxpayer on a cash basis, * * *."

Congress must be presumed to have intended "equality among taxpayers."[21] The taxpayer's interpretation of the disputed phrase results in fair and equal treatment of corporate taxpayers regardless of accounting methods; the theory of the Government renders the section virtually inoperative for accrual basis taxpayers. Only the taxpayer's interpretation can be in harmony with the presumed purpose of Congress.

II.

Section 122(d)(6) Was Designed (Among Other Things) to Allow Corporate Taxpayers, Regardless of Accounting Methods, to take as a Deduction the Amount of Excess Profits Tax Actually Paid In A Loss Year in Determining the Amount of a Net Operating Loss.

It must be emphasized at the outset that Section 122(d)(6) applied if, and only if, a taxpayer incurred a net operating loss; where a taxpayer enjoyed profit years the

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[20] That the purpose of a taxing statute would be frustrated by denial of equal tax treatment because of mere difference in accounting is also indicated by *Commissioner* v. *The Hecht Co.* (CCA-4, 1947) 163 F. (2d) 194, 196 and 199.

[21] *Colgate-Palmolive-Peet Co.* v. *U. S.* (1943) 320 U. S. 422, 425.

section did not apply. The provision involved, therefore, a limited type of situation.

Congress did not define in the staute or in its Reports the meaning of the terms "paid or accrued" when used in Section 122(d)(6).[22] Their meaning must, therefore, be gleaned from an analysis of the words of the statute itself in the light of the legislative purpose as disclosed by the legislative history and corroborated by a collateral line of cases involving a similar principle in a similar type situation.

A. The language of the Code itself proves this by necessary inference.

1. Section 122(d)(6) provided the principal adjustment which could benefit a taxpayer in a loss situation.

Section 122 was captioned, "Net Operating Loss Deduction." Subsection (a) thereof defined a net operating *loss;* subsection (b) described how to convert a net operating loss into a net operating loss carry-back or carry-over and how to determine the amounts thereof; subsection (c) provided rules for converting the carry-backs and carry-overs into a net operating loss deduction and for determining the amount thereof.[23] Sub-section (d) was captioned, "Exceptions, additions and limitations" and was not designed to stand alone. It merely tabulated six adjustments various of which were specifically referred to by subsections (a), (b) and (c). Section 122(a) referred broadly to all the exceptions, additions and limitations

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[22] The words were "ambiguous" as they were capable of being understood in either of two or more possible senses. See *Webster's New International Dictionary,* 2nd Ed. (1940) p. 81.

[23] This was the "plainly established trichotomy" referred to in *Reo Motors, Inc.* v. *Commissioner* (1950) 338 U. S. 442 at 446-447. The case is otherwise not in point. It stands for the rule that "net operating loss" must be determined under the law in effect in the loss year, not the law in effect in the year of the net operating loss *deduction.*

provided in subsection (d). Section 122(b) and its various subparagraphs referred only to adjustments numbered (1), (2), (4) and (6). Section 122(c) referred only to adjustments (1), (2) (3) and (4). Only subsections (a) and (b), therefore, involved the (d)(6) adjustment.

Of the six adjustments listed under section 122(d), four of them—numbers (1), (3), (4) and (5)—either eliminated or reduced specific deductions claimed on returns. One of them—(d)(2)—required the inclusion of tax-exempt interest income less non-deductible interest on debts incurred to buy tax-exempt obligations. The first five adjustments[24] together constituted the "exceptions" and "limitations" re-

[24] The first five adjustments provided as follows:

"(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114(b), (2), (3), or (4);

"(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23(b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

"(3) No net operating loss deduction shall be allowed;

"(4) Gains and losses from sales or exchanges of capital assets shall be taken into account without regard to the provisions of section 117(b). As so computed the amount deductible on account of such losses shall not exceed the amount includible on account of such gains."

"(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions and limitations specified in paragraphs (1) to (4) of this subsection."

ferred to in the caption. The sixth adjustment—the one here involved—allowed as a deduction the amount of excess profits tax imposed paid or accrued within the taxable year. This adjustment was the "addition" [25] referred to in the caption of Section 122(d) because it allowed an amount not deductible[26] on a return to be "added to" the excess of deductions over gross income.[27]

Of all the adjustments under (d), number (6) here involved was the *only one beneficial* to taxpayers once a loss had been incurred.[28] It tended to increase that loss by providing an additional deduction, thereby increasing the amount of the carry-back and the net operating loss deduction. This, of course, could result in a refund of overpayments for a prior year.

2. The excess profits tax paid under Section 122(d)(6) was not a *conventional* deduction under Section 23; therefore "paid or accrued" did not necessarily refer to accounting methods and Section 48(c) was inapposite. A question arises as to the exact significance of the phrase appearing in Section 122(d)(6), "there shall be allowed as

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[25] Note that the word "additions" was added to the caption of Section 122(d) by the same section of 1942 Revenue Act which enacted Section 122(d)(6).

[26] As subsequently explained, excess profits tax could not be deducted in computing corporate net income per return in 1946.

[27] The simple excess of deductions over gross income referred to in Section 122(a) was not named in the Code. It may be referred to by the non-technical term "net loss" to distinguish it from "net operating loss" which contained in addition the adjustments provided in subsection (d).

[28] This is not surprising in view of the fact that the (d)(6) adjustment was a statutory descendant of former Section 23(c)(2). Congressional benevolence which formerly had permitted a deduction under that section for excess profits tax had, by the 1942 Revenue Act, discontinued the deduction for technical reasons and allowed instead the Section 122(d)(6) adjustment and a Section 26(e) credit. These two did not duplicate but rather tended to complement each other; one applying in loss and the other in profit years.

a deduction," with reference to excess profits tax "paid or accrued." The Government contends that this language required that the adjustment for excess profits tax paid or accrued be regarded as a conventional deduction, subject to the usual rules of statutory construction. *Yet Section 23(c)(1)(B) specifically excepted excess profits tax paid or accrued from those which were deductible generally in 1946.* Excess profits tax was placed among the *exceptions* by the identical section of the Revenue Act of 1942 which added Section 122(d)(6) to the Code.[29]

The taxpayer concludes, therefore, that Congress could not have intended the word "deduction" in Section 122(d)(6) to be the conventional, Section 23,[30] type of deduction.

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[29] Section 105(d) of the Revenue Act of 1942 amended Section 23(c)(1)(B) of the Code by adding excess profits tax to the non-deductible ones. Section 105(e)(3) added subparagraph (6) to subsection 122(d) of the Code.

[30] This is expressly demonstrated by the following situation. Under Section 102(d)(1)(A), net income was required to be reduced by "excess profits taxes * * * paid or accrued during the taxable year, to the extent not allowed as a deduction by Section 23". In the absence of a saving clause, this language obviously would have included taxes under Chapter 2E which were not allowed as a deduction by Section 23(c)(1)(B). Therefore, to accomplish Congress' purpose of non-deductibility of Chapter 2E tax under Section 102, a parenthetic phrase appeared after the word "taxes" quoted above, couched in the following language:

> "(other than the tax imposed by Subchapter E of Chapter 2 for a taxable year beginning after December 31, 1940)".

This illustrates that taxes under Chapter 2E were *not* Section 23 "deductions" otherwise there was no need for the words in parenthesis.

Compare the situation under Section 505(a)(1) where net income was also required to be reduced by "excess profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under Section 23". Here, no parenthetic exception appeared and Chapter 2E taxes were, therefore, proper adjustments.

What may have been intended was that "the *amount*[31] of tax imposed" (either paid or accrued) should be "added to" the excess of deductions over gross income thereby tending to increase the amount of the net operating loss just as if it actually had been an additional deduction for this limited purpose.[32] The fact that conventional Section 23 "deductions" were *not* involved renders the Government's Argument I aside from the point. Sections 41, 43 and 48(c) are inapposite, therefore, as are the cases cited on pp. 13-14 of the Government's Brief. "Paid or accrued," therefore, were not controlled by these sections. This is not to deny, of course, that *conventional* deductions should be treated as the Government argues.

3. Other sections of the Code reveal a well-established Congressional technique of making tax "paid or accrued" adjustments *to* net income not controlled by Section 48(c). While somewhat out of the ordinary, the adjustments provided by Section 122(d) to be made to Section 122(a) bore a family resemblance to several other Code provisions in effect in mid-1940. Among such cousins were Sections 102(d)(1), 336(a), 505(a) and 711(a)(1) and (2). Although these sections related to such dissimilar corporate loopholes as improper accumulation of surplus, foreign and do-

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[31] Perhaps this was Congress' way of permitting the adjustment under Section 122(d)(6) even though excess profits taxes were technically non-deductible. That is, only the "amount" of tax imposed was allowed to be "added" to the loss; the tax itself was not to be deducted. Whatever the rationalization, the non-deductibility is clear.

[32] The Court below felt that it would have to make an exception to the general rule prohibiting "shifting" from one method of accounting to another to "give effect to the plain intention of Congress". The taxpayer believes that such intent can be given effect without taking that position, simply by relying on the distinction here noted. This also disposes of the Government's suggestion that taxpayer is inconsistently seeking to shift some but not all of its operations to a cash basis. Bases of accounting have no place in this problem.

mestic personal holding companies and excess profits, they did have a common feature. This was the fact that each related to a "super-surtax" [33] or a tax imposed above and beyond normal taxes. In each case, the base upon which the "surtax" was levied was not ordinary net income but a different statutory concept above and beyond net income.[34]

Various adjustments were specified in the respective sections to convert net income in each case to the new base for tax. The adjustments themselves tended to differ between sections depending upon considerations germane to the particular legislative purpose in each case. Yet one similar type of adjustment was found in both of the personal holding company sections as well as Section 102. It was for Federal taxes paid or accrued.

In these three sections, otherwise non-deductible Federal taxes were allowed to *reduce* net income (the personal holding company provisions referred to "additional deductions" and Section 102 used a "minus"). And in each instance the taxes were described as "paid or accrued during the taxable year". In every case construing these provisions[35] it has been held uniformly that "paid or accrued" referred to transactions, not accounting methods; a tax base beyond net income was being computed and Section 48(c) did not apply.

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[33] See *7A Mertens, supra*, (1943 Ed.) 5 *et seq.* The term is Mertens'. He lists, in addition to those named, the declared value excess profits tax, the unjust enrichment tax and the tax on excess profits on Navy contracts.

[34] The respective terms were:

Section 102(d)(1)—net income into "section 102 net income"

Section 336—net income into "Supplement P net income"

Section 505—net income into "Subchapter A net income"

Section 711(a)—normal tax net income into excess profits net income

[35] Section 102(d)(1) was thus construed in *Harry M. Stevens, Inc.* v. *Johnson, supra.*

Section 505(a)(1) was construed in *Wm. J. Lemp Brewing Co., supra, Aramo-Stiftung* v. *Commissioner, supra*, and *Birmingham* v. *The Loetscher Company, supra.*

The parallel between these provisions and Section 122(a) and (d)(6) is striking. Net loss (excess of deductions over gross income—negative net income) under Section 122(a) had to be adjusted for the "exceptions, additions and limitations" provided in subsection 122(d). These adjustments converted "net loss" into "net operating loss". The (d)(6) adjustment was a deduction for excess profits taxes "paid or accrued within the taxable year." As a negative (or deduction) factor it tended to *reduce* net income or, in a loss year, *increase* net loss. While the "net operating loss" was not a base for a surtax it was a negative base for the negative of tax—a refund (from carry-back and deduction).

From the foregoing, it is discernible why Congress used the technique it did in Section 122; from 1934[36] to the present time[37] Congress has used the type of device described. It is not surprising therefore, that Congress, in legislating on a matter involving payment or accrual of a non-deductible excess profits tax (a super-surtax itself), should follow its own pattern and adopt almost identical language used before appropriately adapted, however, to the requirements of a loss rather than a surtax situation. The Congressional intent in using "paid or accrued" in the similar provisions was firmly established. What was intended there must have been intended here.

4. Congress quite apparently devoted a considerable amount of time and attention in drafting detailed provisions regulating the implications and ramifications of Section 122(d)(6) and to avoid duplication of benefit to taxpayers by that provision; any further restriction by Courts

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[36] See Section 351(b)(1)(A) of the Revenue Act of 1934 relating to personal holding company "adjusted net income."

[37] See Section 545(b)(1) of the Internal Revenue Code of 1954 where, in a personal holding company situation, certain excess profits taxes are allowed as a deduction from "taxable income" when paid (if previously reported on a "when paid" basis) unless by irrevocable election they are to be reported hereafter when "accrued."

through a narrower construction of "paid or accrued" than intended by Congress would be unwarranted.

The general flavor of the Government's Brief is that the Congress "overlooked" a lot of things in connection with Section 122(d)(6). The facts are to the contrary. The implication, however, is that this Court should legislate that which was overlooked and, presumably, hold the Section inapplicable to accrual basis taxpayers (with rare exceptions).

The following examples from the Code of detailed Congressional interest in Section 122(d)(6) may be cited:

(a) Congress provided three qualifying rules under (d)(6) dealing with matters as diverse as allowance of the full amount of excess profits tax paid unreduced by the foreign tax credit, the non-applicability of a technical loophole-plugging provision involving adjustments in the case of inconsistent positions and allocation of tax in the case of a consolidated return;

(b) Wherever the (d)(6) adjustment was referred to in Section 122 no reference was made to a Section 26(e) credit (for example, subsections (a), (b) and (d)); conversely, where reference to the Section 26(e) credit was made, the (d)(6) adjustment did not appear (as in Section 122(c)). The (d)(6) adjustment, therefore, was to apply in such a way that there would be no duplication of benefits[38] by having a Section 26(e) credit allowed in the same year;

(c) Sections 122(b)(1)(A) and (b)(2)(A),[39] allowed the

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[38] Wherever there was a Section 26(e) credit, that indicated a profit year, such as the year of *deduction* of a net operating loss. In a loss year under 122(a) there could be no Section 26(e) credit (there being no adjusted excess profits net income). Even under Section 122(b)(1) where the (d)(6) adjustment occurred in a profit year (second year preceding the loss year) *only* the (d)(6) adjustment was allowed and not the Section 26(e) credit.

[39] These sections related to the net operating loss carry-back and carry-over types of situation. For example, in determining the amount of the carry-back to the year *first* preceding the year of

(d)(6) adjustment in harmony with the Congressional concept that payment of an excess profits tax was an "economic loss";

(d) The insertion of Sections 711(a)(1)(J) and (a)(2)(L) in the Code (by the 1942 Revenue Act) indicated Congressional preoccupation with the area of impact of Section 122(d)(6) and further indicated a deliberate attempt to curtail its operation. It would be unwarranted, therefore, to go beyond the limits Congress itself placed on the section[40] and add a significantly greater limitation by applying Section 48(c);

(e) Section 26(c)(2) carefully avoided an adjustment comparable to Section 122(d)(6) (although adopting the (d)(1), (2) and (3) adjustments) in a section of very narrow application controlling net operating loss carry-over credits in matters relating to Section 102 net income, Supplement P net income and Subchapter A net income.

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loss, the net operating loss had subtracted *from it* the net income of the *second* preceding year after it had been adjusted for the 122(d)(1), (2), (4) and (6) factors. As the payment (or accrual but not *both*) of an excess profits tax in the second year preceding the loss year was an economic loss in that year, the statute permitted the amount of such payment (or accrual) to *reduce* net income at that time thereby *increasing pro tanto* the amount of the carry-back "overflow" to the year first preceding the loss year.

[40] It may be noted that while Section 122(d)(6) was a part of the original 1942 Revenue Bill as originally introduced in the House, the subsections of 711 referred to were first introduced as Senate floor amendments and were in turn amended by the Conference Committee. These provisions had been suggested by the Congressional legislative drafting staff and had been submitted to the Treasury where they had been approved. Apparently, they were inserted solely for the purpose of eliminating duplications and other imperfections in the net operating loss carry-over provisions as they applied to the computation of excess profits net income. See 88 *Congressional Record* 8015—discussion by Mr. George: H. R. No. 2586, 77th Cong., 2d Sess., Amendment No. 291

It scarcely seems reasonable to suppose that the Congress drafted these complicated provisions using "paid or accrued" in an accounting sense in Section 122(d)(6) which would have the inevitable effect of virtually emasculating that section and the other mentioned. Yet that is what Congress intended, the Government insists[41]).

B. The Clarion Oil Company line of cases has established the rule: "Paid or accrued" may have different meanings under the Code; where necessary to produce a new statutory concept beyond net income these words may be given their ordinary meaning and not that of Section 48(c).

The *Clarion Oil* case, 148 F. (2d) 671, involved a cash basis taxpayer which paid its 1937 income and excess profits taxes in 1938. The question involved was the taxpayer's right to compute its "undistributed net income" for 1937 by subtracting from its net income for that year the amounts of income and excess profits taxes which "accrued" in 1937 but which were "paid" in 1938. The United States Court of Appeals for the District of Columbia refused to follow the Tax Court in holding that the word "accrued" had to be construed with reference to the manner in which the taxpayer kept its accounts; it held that accounting methods were connoted by the terms "paid or accrued" *only when* net income was being determined. Speaking with reference to the definition of "paid or accrued" used in Section 48(c) (also relied on in this case by the Government) the Court of Appeals said at 675:

> "But obviously, this definition was intended to apply to the method of computing *net income*, and has no

[41] The Government's construction of the disputed words suggests analogy to the classical: "When I use a word," Humpty-Dumpty said, "it means just what I choose it to mean—neither more nor less." *Through the Looking Glass and What Alice Found There*, "Lewis Carroll."

> reference or relevancy to the subject matter of what, for the purpose of the newly added provision in relation to personal holding companies, is taxable as undistributed income.[14] In other words, having determined 'net income' in accordance with the accounting methods of the taxpayer, there is no need to question whether an ordinary income tax was 'paid' or whether it was 'accrued', since in either event it was a deductible item and no longer represented accumulations of income, which it was the intent of this tax to force out of the 'incorporated pocketbook' and into the hands of individual taxpayers." (Emphasis in the original.)

Footnote 14 referred to in the quote held that cases dealing with the deduction of Federal taxes for purposes of "net income" were inapposite, citing as an example *U. S.* v. *Anderson* (1926), 269 U.S. 422. This case and related cases relied on by the Government there (p. 14 of its Brief) are inapposite for the reason indicated.

In discussing the inapplicability of the taxpayer's method of accounting the Court pointed out in *Clarion* that it was enough if the taxes were *either* paid *or* accrued in the taxable year. There was absent the administrative need for uniformity in computing "undistributed net income" (under Section 356(a)(1) of the Revenue Act of 1937) which was essential in the computation of net income.

The Eighth Circuit,[42] the Second Circuit,[43] the Court of Claims,[44] a District Court,[45] and the Tax Court[46] have all agreed with and followed the rationale of the *Clarion Oil* case in construing Section 48(c).

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[42] *Birmingham et al., Exrs.* v. *The Loetscher Company*, 188 F. (2d) 78 at 79.

[43] *Aramo-Stiftung* v. *Commissioner*, 172 F. (2d) 896 at 897.

[44] This case in the court below.

[45] *Reliance Feed & Grain Co., Inc.* v. *Shaughnessy* (DC ND NY, 1949) 84 Fed. Supp. 389 at 390.

[46] *Wm. J. Lemp Brewing Co.*, 18 T.C. 586 at 608.

That construction also has been extended in a recent case[47] to Section 102(d)(1)(A) of the Code involving adjustments to net income to produce "Section 102 net income" by deducting *inter alia* Federal income tax "paid or accrued during the taxable year * * *."

It is true, of course, that Section 122 was a relief provision tending to favor taxpayers by virtue of allowance of net operating loss deductions while the *Clarion Oil* case involved the personal holding company penalty surtax. However, in both situations the adjustments themselves were favorable to taxpayers[48] and there was, moreover, the conceptual affinity of the way in which the adjustments were made. In both cases adjustments were made after the "administrative need for uniformity" had already been satisfied.

The *Clarion Oil* case by analogy also supports the taxpayer's position that adjustments *to* (not deductions used in computing) net loss produced a new statutory concept notably dissimilar—net operating loss. In *Clarion* the new concept was "undistributed net income"; here it was "net operating loss". There the purpose of the adjustments was to create a fair base for a penalty surtax; here the purpose was to create economic loss to be carried back.

C. As disclosed by the legislative history the Congressional intent in using the phrase "paid or accrued" in Section 122(d)(6) was to refer to transactions, not accounting methods.

1. The Revenue Act of 1942 made two significant omissions under Section 122(d)(6), both indicating that Congress referred to *taxes of other years* when it used "paid or accrued" and, therefore, did not intend to refer to

[47] *Harry M. Stevens, Inc.* v. *Johnson*, 115 Fed. Supp. 310 at 312.

[48] The Section 122(d)(6) adjustment tend to *increase* the amount of a net operating *loss* and hence the amount of the carry-back and resulting deduction. In the case of the penalty surtax the adjustment *reduced* the tax base subject to the penalty tax.

accounting methods. These omissions were, respectively, the non-appearance of Rule (A) which had formerly qualified Section 23(c)(2) in a related situation and the absence of the Section 26(e) credit.

Of what significance was the omission of Rule (A)? Congress first enacted an excess profits tax in the general period here under consideration when it passed the Second Revenue Act of 1940 adding Subchapter E to Chapter 2 of the Internal Revenue Code. This Act was approved October 8, 1940, and applied to taxable years beginning after December 31, 1939. For 1940, Section 23(c) of the Internal Revenue Code as it then read permitted a direct deduction of taxes paid or accrued[49] within the taxable year (with certain exceptions) in determining net income. Included among the exceptions were the Chapter 2E excess profits taxes.[50]

Section 202(a) of the Revenue Act of 1941 (approved September 20, 1941) removed excess profits taxes (under Chapter 2E) from the list of exceptions to the general deduction rule and simultaneously added new subparagraph 2 to Section 23(c) which specifically permitted a direct deduction of imposed excess profits taxes in computing net income, subject however to four limiting rules. These provisions were effective as to taxable years beginning after December 31, 1940 or later years. Rule (A) of subparagraph 2 of Section 23(c) effectively placed all taxpayers on the accrual basis of accounting with respect to the excess profits tax payments for a taxable year. Rule (A) read:

> "The deduction shall be limited to the tax imposed for the taxable year but any portion of such tax paid after the taxable year shall be considered as having been paid within the taxable year; * * *."

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[49] In this context "paid or accrued" admittedly related to accounting methods.

[50] See Section 506(b) of the Second Revenue Act of 1940 amending Code Section 23(c)(1).

The Revenue Act of 1942[51] (approved October 21, 1942), by Section 105(c) thereof, repealed Section 23(c)(2) of the Code and simultaneously restored excess profits taxes to the list of exceptions to the deduction rule. The very same section[52] of the 1942 Revenue Act which restored excess profits to the list of exceptions to the tax deduction provisions added the new provision—Section 122(d)(6)—to the Internal Revenue Code. Pertinent language in the Senate Report[53] was as follows:

> "Section 122 of the Code relating to computation of the net operating loss deduction allowed by section 23(s) of the Code, is amended so as to *allow* the excess profits taxes paid or accrued within taxable years (subject to certain rules) as a deduction in computing net operating loss for, and net operating loss carry-over and carry-back from, such taxable years."[54] (Emphasis supplied)

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[51] This Act effected a major revision of the tax laws during the war period. Of importance here is the fact that it altered significantly the method of computing excess profits tax liability. Prior thereto the excess profits tax had been computed like an additional surtax and had been reflected on the income tax return form. Under the new act, separate tax bases were provided for the computation of the two taxes, the so-called "two-basket" principle. See H. R. No. 2333, 77th Cong., 2d Sess., p. 18.

[52] Section 105.

[53] No. 1631, 77th Cong., 2d Sess., p. 67; see also H. R. No. 2333, 77th Cong., 2d Sess., p. 65.

[54] It may be observed that this language indicated a clear intention to *allow* the adjustment enacted as Section 122(d)(6). This emphasis should be unnecessary but in view of the impression given by the Government Brief it must be made. That Brief implies that Congress wrote the section to *disallow* the adjustment. See Argument I and I.A.

Rules (A), (B) and (C) qualifying Section 122(d)(6) were almost verbatim copies of Rules (B), (C) and (D) formerly appearing in Section 23(c)(2).[55] Significantly, Rule (A) which had appeared under Section 23(c)(2) did not reappear under Section 122(d)(6). This was the rule which had effectively placed all taxpayers on the accrual basis with respect to excess profits tax *payments*.

Recalling that the professed purpose of Congress in enacting Rule (A) under Section 23(c)(2) had been to accord all taxpayers, cash and accrual, the *same treatment*[56] with respect to the deduction of payments for excess profits tax, a question arises as to the significance of the apparently deliberate omission of Rule (A) from Section 122(d)(6). Maxims[57] of judicial construction suggest that the deliberate omission of Rule (A) indicates as a minimum that Congress did *not* thereby intend to have all taxpayers on the accrual basis under Section 122(d)(6) as they had been under Section 23(c)(2).

Another conclusion also seems warranted. As Congress intended in 1941 to accord both cash and accrual taxpayers the *same* treatment with respect to the adjustment for excess profits tax, it can scarcely be supposed that Congress by the enactment in 1942 of Section 122(d)(6) omitting Rule (A) intended to accord cash and accrual taxpayers a *dissimilar* treatment simply because of a change in the base for corporate tax. Certainly it should require a clear expression of intent to warrant a conclusion that

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[55] A word-by-word comparison of the related rules leads to the conclusion that the legislative draftsmen must have had the prior language before them in drafting the rules under Section 122(d)(6).

[56] This was flatly stated in H. R. No. 1040, 77th Cong., 1st Sess., p. 46 and S. R. No. 673 (Part 1) 77th Cong., 1st Sess., p. 37.

[57] *Inclusio unius est exclusio alterius*, for example.

Congress was abandoning equality[58] for discrimination, and the taxpayer can find none.

This much seems self-evident. What more may be inferred? The answer is found by considering the effect of Rule (A) *if* it had been enacted under Section 122(d)(6). That Rule under Section 23(c)(2) required a cash basis taxpayer to consider an excess profits tax paid *after* a taxable year as having been paid within the taxable year, the deduction being limited to the tax imposed in a profit year. This placed the cash and accrual basis taxpayers upon the same exact footing. While such a result was desirable and necessary, under Section 122(d)(6) such a Rule would have been meaningless.

In the first place, the taxable year would have been a *loss* year. Therefore, the cash basis taxpayer could have had *no* excess profits tax *liability* in the taxable year. But this would not have placed the cash basis taxpayer at a disadvantage for the accrual basis taxpayer likewise would have had no "accrued" tax liability in a loss year. These facts explain the absence of Rule (A) as unnecessary. They also warrant another conclusion.

When Congress left out Rule (A) it must have done so on the basis of the foregoing analysis. That analysis, of course, implicitly recognized that where the *taxable* year was a *loss* year, neither a cash nor an accrual basis taxpayer ordinarily could "accrue" an excess profits tax "*within the taxable year*". Nor would a tax be paid in the year imposed.

It is apparent, therefore, that neither "paid" nor "accrued" used in Section 122(d)(6) could have been intended to refer to methods of accounting. "Paid or

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[58] "A desire for equality among taxpayers is to be attributed to Congress rather than the reverse." *Colgate-Palmolive-Peet Co.* v. *U.S.* (1943) 320 U. S. 422, 425.

accrued" in such a context would have been as inapposite as Rule (A). These terms must have referred of necessity to taxes of *prior* years[59] which were discharged by payment (paid) or which arose (accrued) in the taxable (loss) year. These are "transactional" meanings not "accounting methods" ones for these results would have been the same regardless of accounting methods.

The other omission occurred for the same reason and warrants the same conclusion. Section 105(e) of the Revenue Act of 1942 was captioned, "Technical Amend-

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[59] There is an earlier example of this type of construction. Under the 1936 Revenue Act personal holding companies were allowed deductions in computing adjusted net income of "not only ordinary Federal income and profits tax paid during the taxable year but also the special tax under Section 102." (H.R. No. 1546, 75th Cong., 1st Sess., p. 711-2. See S. R. No. 1242, same session) Thus, where a company paid during a current year, Section 102 taxes assessed for prior years, a benefit was gained, the Report explained. But Congress had not intended that Section 102 surtaxes should be paid out of current earnings. It had been intended that they should have been paid out of accumulations. Therefore, it was proposed that the 1937 Revenue Act amend Section 351 (of the 1936 Revenue Act) by making the Section 102 taxes specifically non-deductible

Of significance is the fact that the amendment was made, not because of any question of accounting methods, but rather on the basis of Congressional policy as to Section 102. But more important is the fact that while Section 48(c) (defining paid or accrued to mean accounting methods) appeared in the 1936 Revenue Act as well as the 1937 Revenue Act it was flatly stated that taxes "paid during the taxable year" were deductible with no reference to accounting methods. While the amendment affected Section 102, no attempt was made to change the provisions allowing deductions for income and profits taxes "paid or accrued".

ments[60] Made Necessary By Change in Base for Corporate Tax." Section 105(e)(3) added Section 122(d)(6) to the Code. Sections 105(e)(1) and (2) related, respectively, to the credit for dividends received and to the computation of Section 102 net income. These two subparagraphs contained specific references to the newly added Section 26(e) credit (amount subject to excess profits tax). In each case, that credit was allowed as a reduction. But no reference to the Section 26(e) credit appeared in Section 105(e)(3) of the 1942 Revenue Act relating to Section 122(a) and (d)(6)—although Section 122(c) was amended by that Act to require a normal tax net income computation "without" such credit.

The reason is obvious. As there could be no excess profits net income in a loss year by definition[61] the 26(e) credit would always be naught in such a context. For the same reason, no excess profits tax liability could arise to be "accrued" in a loss year. Taxes were not paid in the

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[60] The Government makes an argument based upon the phrase "technical amendments", the substance of which is that there was something mutually exclusive in the concept of "technical amendments" on the one hand and a significant change in the law on the other. Assuming but not conceding that Section 122(d)(6) was a significant change, the basis of the Government's argument is not correct. The two subsections of Section 105(e) of the Revenue Act of 1942 immediately preceding subsection (3), which added the operating loss provisions here in issue, deal respectively with the credit for dividends received and computation of Section 102 net income. It can scarcely be considered that these provisions are any less significant than those relating to the occasional impact of a net operating loss. Moreover, other legislation bearing the caption of "technical" has dealt with more than narrow technical matters. See as a recent illustration the Technical Changes Act of 1953, 67 Stat. 615.

[61] See footnote 38, *supra*.

year imposed but in the subsequent year and none would be "imposed" in a loss year. It must be concluded, therefore, that the absence of the Section 26(e) credit in Section 122(a) or (d)(6) meant that the excess profits tax "paid or accrued" could not have referred to the tax *for* the loss year but must have related to the tax of a prior year. That being so, "paid or accrued" must have been used in a transactional sense.

2. The purpose of the Section 122(d) adjustments and (d)(6) in particular was to help convert net loss into economic loss. The frame of reference for this problem must take cognizance of the fact that the Revenue Act of 1942 amended the excess profits tax law so as to make the rates high enough to be confiscatory in nature.[62] It is not surprising therefore that Congress, to alleviate some hardship in such circumstances, liberalized certain pre-existing relief provisions[63] and enacted new ones.[64]. Among

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[62] The Congressional intention was stated to be a "desire that the rearmament program should furnish no opportunity for the creation of new war millionaires or the further substantial enrichment of already wealthy persons." The provisions were applicable to all corporations whether or not directly engaged in the defense program. This Act increased the tax rates from a graduated scale ranging from 35 to 60 percent to a 90 percent rate, however, with an over-all limitation of 80 percent subject to a postwar credit of 10 percent. Compare H. R. No. 2894, 76th Cong., 3d Sess., p. 2.

[63] "The 1942 Act amendments substantially broadened the relief provisions, increasing their elasticity." See *7A Mertens, Law of Federal Income Taxation*, (1943 Ed.) 18. One illustration bearing a close analogy to the provisions here in question was the allowance of a two-year carry-back of unused excess profits credits under Section 710(c)(3)(A). That provision was added by Section 204(b) of the Revenue Act of 1942 and was made retroactive to 1941.

[64] Perhaps the most important was Section 710(a)(1)(B) permitting an alternative computation of excess profits tax liability based upon 80 percent of corporation surtax net income less income tax liability.

the existing relief provisions which were expanded were those relating to net operating losses here involved.[65]

It is clear that Congress intended all six adjustments under Section 122(d) to have the effect of sterilizing net income or net loss as the case might be of all non-economic factors. Stated otherwise, the purpose was to convert net loss (excess of deductions over gross income) into economic loss[66] called "net operating loss".

Where a taxpayer "paid" an excess profits tax that transaction had an operational aspect and parting with cash was certainly an economic loss. By the same token the coming-into-existence of an excess profits tax liability by settlement of a dispute, for example, met the same tests.

As already indicated, the adjustments under Section 122(d) were variously referred to by subsections (a), (b), and (c). It follows, therefore, that the Congress not only provided that a net operating loss as defined should be sterilized of all non-economic loss elements but it applied the same concept in the computation of the amount of the net operating loss carry-backs and carry-overs, as well as in the computation of the amount of the net operating loss deduction itself. In the latter situations net income (not net loss) was converted into economic net income. Thus, even though the net operating loss *deduction* as finally determined under Section 122(c) was allowed as a deduction in computing net income by Section 23(s), it is inaccurate to describe and imply, as the Government does, that the adjustment provided by Section 122(d)(6) was a conventional deduction and *directly* involved in computing net income.

A number of convolutions were involved in going from the payment of an excess profits tax in a loss year to the

[65] Significantly, the 1942 Revenue Act for the first time since the 1918 Revenue Act permitted a two-year carry-*back* of a net operating loss. See Section 122(b)(1).

[66] See House Ways and Means Committee Report No. 855, 76th Cong., 1st Sess., p. 17.

allowance of a deduction for a net operating loss in a prior year. During the course thereof it was quite possible that the (d)(6) adjustment could have been offset, consumed or otherwise altered so as to give no direct benefit as a deduction. The somewhat complicated computations required by Sections 122(b) and (c) in particular suggest a remote rather than a direct relationship.

More important, the amount of the net operating loss *deduction* depended primarily upon the amount of net operating loss carry-overs and carry-backs from *other years*. Necessarily, therefore, the deduction itself was not controlled by Sections 43 or 48(c) of the Code, for the deduction obviously was neither paid nor accrued *in* the year the deduction was sought. Only in the years where the net operating *losses* were incurred could the "paid or accrued" question really arise, and in those years, as already indicated, Section 48(c) does not apply.

Summarizing Argument II thus far, it has been established that:

The (d)(6) adjustment, enacted by Congress in an era of high taxes but in a spirit of tax relief, tended to benefit taxpayers who incurred losses. The adjustment itself was not a conventional deduction but involved treating an excess profits tax either paid or accrued "as if" it were a deduction. This adjustment, coming as it did after the prior determination of net income (or net loss) was not controlled by Section 48(c) and served to produce a new statutory concept, economic loss, which was typical of a number of similar concepts frequently used by the Congress.

Congress did not expressly define "paid or accrued" when used in Section 122(d)(6). It did, nevertheless, devote considerable attention and statutory language to the problems related to and created by Section 122(d)(6) which indicates the Congressional intent in this respect. The most significant deduction warranted is that Congress was

not referring to taxes of the loss year itself when using the language "taxes paid or accrued within the taxable year." That this would have been an anomaly was indicated by the deliberate omission of both Rule (A) and the Section 26(e) credit from Section 122(d)(6). Because the taxes referred to as "paid or accrued" could not have related to the taxable year itself, they must have related to a prior taxable year. That being so, the only plausible meaning of the words would be in the transactional sense, the accounting method sense being inapposite.

Ironically, every attack which the Government makes on the taxpayer's position would, if valid, apply with equal force where a cash basis taxpayer paid an excess profits tax in a loss year. Yet the necessary logic of the Government's accounting method argument is that a cash basis taxpayer should benefit in such a situation. Such an inconsistent and untenable position suggests that the Government's real argument is that it does not agree with the Congress and, therefore, Section 122(d)(6) should not apply.

D. Even if it be held that "paid or accrued" literally referred to methods of accounting described in Section 48(c) when used in Section 122(d)(6), this Court may construe the quoted words to refer to transactions rather than accounting methods, if the former was the purpose even though not the literal meaning of the provision.

The supremacy of purpose over language was stated in *U. S. v. American Trucking Associations*, (1940) 310 U. S. 534, 543. Where words have a perfectly plain meaning that should be followed; however, where that meaning has led to absurd or futile results, this Court has looked beyond the words to the purposes of the act. This has been done even where the plain meaning did not produce absurd results but merely unreasonable ones which were, however, plainly at variance with the policy of the legislation

as a whole.[67] As previously pointed out, the Government's argument produces gross inequities which are far beyond mere "unreasonable" results. Moreover, the taxpayer has demonstrated that the purpose of the legislation was to grant relief to taxpayers incurring losses by permitting excess profits tax paid in the loss year to be treated as a deduction in converting to economic loss. This was the purpose. If the result is otherwise because of literal meaning, then the purpose has not prevailed.

III.

The Fortuitous Occurrence of a Net Operating Loss in 1947 Which Produced a Net Operating Loss Deduction for 1945 and Hence Resulted in a Refund or Credit of That Year's Taxes Including the Excess Profits Tax Paid in 1946 Does Not, as a Matter of Law, Prevent the Deduction of Excess Profits Tax Paid in the Year 1946.

It was a sad fact that the taxpayer incurred a net operating loss in 1947 as well as in 1946. This fortuitous and unpleasant occurrence produced a net operating loss carryback from 1947 to 1945 where, after conversion into a net operating loss deduction, the 1945 excess profits tax liability was eliminated. The result was that refunds or credits were made to the taxpayer in 1947 and 1948[68] of the excess profits taxes for 1945 which had been paid in 1946. The Government concludes, therefore, that the taxpayer suffered no economic loss in 1946 by virtue of payment in 1946 of the 1945 excess profits tax liability.

Emphasizing the word "imposed" in Section 122(d)(6), the Government argues that because the excess profits taxes

[67] See also *Helvering* v. *Morgan's Inc.* (1934) 293 U. S. 121, 125; *Markham* v. *Cabell* (1945) 326 U. S. 404 at 409; *Farmers' Reservoir & Irrigation Co.* v. *McComb* (1949) 337 U. S. 755 at 764 and *Takao Ozawa* v. *U. S.* (1922) 260 U. S. 178 at 194.

[68] R. 10.

were subsequently refunded they did not represent an amount of tax actually imposd; only one excess profits tax was imposed for 1945 and that was the amount which was *finally* determined after application of the 1947 carry-back. The Government then cites some language out of context from the companion case of *Lewyt Corporation* in the Second Circuit Opinion and refers to a brief to be filed in Docket No. 417, the *Lewyt Corporation* case before this Court on certiorari. The same argument was raised by the Government in the proceeding below but was not even adverted to by the Court of Claims in either of two majority opinions or two dissenting opinions.

The taxpayer's position is that the payment of excess profits taxes in 1946 was, in a very real sense, an economic loss as the taxpayer was thereupon deprived of the use of $263,272.80.[69] The fact that the taxpayer recovered this amount by credit or payment several years later cannot obscure the fact that the taxpayer did suffer an economic loss by payment in the year 1946. That tax had been "imposed"; it had accrued in 1945 and had been paid in 1946.

A contrary view would be incompatible with this Court's opinion in *Manning* v. *Seeley Tube & Box Co., supra.* The "deficiency" referred to in that case, as computed under Section 271 of the Code, meant the amount "by which the *tax imposed*" exceeded the tax shown on the return. Necessarily, therefore, that opinion holds that a tax originally due for a taxable year was imposed even though a subse-

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[69] There is a reverse analogy between this situation and that in *Manning* v. *Seeley Tube and Box Co.* (1950) 338 U. S. 561. In that case this Court regarded as significant the fact that a taxpayer had retained the use of tax funds which rightfully should have been in the possession of the United States. The Government was properly entitled to have and to use the mony owed to it during the period it was owed. Thus, interest on the tax deficiency was properly payable regardless of later elimination of such a deficiency by a subsequently incurred net operating loss.

quent net operating loss carry-back might eliminate tax liability for that year.[70]

Section 56(a) of the Code required a taxpayer to pay "the tax imposed by this Chapter" in the year following the taxable year. Necessarily, that tax "imposed" must have been prior to any net operating loss carry-back as no carry-*back* could have existed at such a time. Moreover, Section 122(d)(6) speaks of a tax imposed "paid or accrued *within* the taxable year" and not to events in a subsequent taxable year. The Government reads the quoted phrase as though it referred to taxes "finally imposed for

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[70] With respect to this matter this Court stated at 566 and 567:

"The enactment of the carry-back provision in 1942 did not change this policy of the statute requiring prompt payment. This section was intended to afford taxpayers an opportunity to present for tax purposes a realistic, balanced picture of their profits and losses. It permits a taxpayer to add a net operating loss for one year to the deductions for the two previous taxable years. The Report of the Senate Committee on Finance states that the purpose of the section was to afford relief to cases where maintenance and upkeep expenses were deferred to peacetime years because of wartime restrictions. S. Rep. No. 1631, 77th Cong., 2d Sess., 51-52 (1942). But there is no indication that Congress intended to encourage taxpayers to cease prompt payment of taxes. The same Report, explaining the operation of the section which became the present carry-back provision, states, 'A taxpayer entitled to a carry-back of a net operating loss or an unused excess profits credit . . . will not be able to determine the deduction on account of such carry-back until the close of the future taxable year in which he sustains the net operating loss or has the unused excess profits credit. *He must therefore file his return and pay his tax without regard to such deduction*, and must file his claim for refund at the close of the succeeding taxable year when he is able to determine the amount of such carry-back.' S. Rep. No. 1631 at 123-124. (Italics added) We can imagine no clearer indication of a Congressional understanding and intent that the carry-back was not to be interpreted as deferring or delaying the prompt payment of taxes properly due."

the taxable year". Since subsequent events may not be taken into account in determining payment or accrual,[71] the only tax imposed, which was paid or accrued within the taxable year 1946, was the tax *paid* in 1946, no tax liability having arisen with respect to the year 1946.

It does seem apparent, however, that the word "imposed" should not necessarily have been confined either to the initial or the ultimate tax liability; it had an ambulatory meaning appropriate in either case. As used here it was only descriptive of a statutory liability for tax and not designed as a limitation.

The Commissioner of Internal Revenue apparently regards the word in the same light as does the taxpayer and in a similar context. A recent ruling relating to Section 102(d)(1)(A) of the Code, which permitted a deduction from "Section 102 net income" for "income, war profits, and excess profits taxes * * * paid or accrued during the taxable year * * * but not including the tax imposed by this section * * *," held that even though such taxes were ultimately refunded as a result of a subsequent net operating loss carry-back, nevertheless the above deduction was to be determined without regard to such carry-back.[72]

The effect of the Government's argument is to nullify the annual accounting concept embedded in the tax system for many years.[73] The Government here reads the word

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[71] *Security Flour Mills Co.* v. *Commissioner* (1944) 321 U. S. 281 at 285 and 286; *Stanard-Tilton Milling Co.* (1944) 3 T.C. 1026 at 1029 and 1030, Acq., 1944-1 Cum. Bull. 3.

[72] Rev. Rul. 6, 1953-1 Cum. Bull., 120; see also Rev. Rul. 55-28, Int. Rev. Bull. No. 3, January 17, 1955, p. 65.

[73] This Court stated in *Edwin E. Healy* v. *Commissioner* (1953) 345 U. S. 278 at 284:

> "Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the counting must be done over again to reflect events occurring after the year for which the count is made, and would

"imposed" as though it had some magic significance. The term has not been specifically defined in any statute so far as the taxpayer can determine. However, some indication of the Congressional understanding of the meaning of that word appears in the language of the House Ways and Means Committee Report filed in connection with the Revenue Code of 1954 which stated:[74]

> "The use of the word 'imposed' rather than 'levied, collected, and paid' is only a modernization of language."

CONCLUSION

For the reasons above-stated, the judgment of the Court of Claims should be affirmed.

Respectfully submitted,

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violate the spirit of the annual accounting system. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the government in a particular case that a different rule be followed."

While it is true that net operating loss carry-back provisions are in themselves something of a modification of the annual accounting concept, this is not to concede tha a simple paymen of tax occurring in a loss year is anything but an economic loss. The effect of the Government's argument is to admit that a payment in 1946 was an economic loss at that time but to deny that it was an economic loss in 1948.

[74] H. R. No. 1337, p. A9, accompanying H. R. 8300. (83 Cong., 2nd Sess.)

APPENDIX A

INTERNAL REVENUE CODE OF 1939*

* The Code provisions cited are those which were in effect in 1944 or 1946 as the case might be as last amended.

"SEC. 13. NORMAL TAX ON CORPORATIONS.

"(a) Definitions.—For the purposes of this chapter—

* * * * *

"(2) NORMAL-TAX NET INCOME.—The term 'normal-tax net income' means the adjusted net income minus the credit for income subject to the tax imposed by subchapter E of Chapter 2 provided in section 26(e) and minus the credit for dividends received provided in section 26(b)."

(As amended by Section 105 (a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798.)

* * * * *

"SEC. 15. SURTAX ON CORPORATIONS.

"(a) CORPORATION SURTAX NET INCOME.—For the purposes of this chapter, the term 'corporation surtax net income' means the net income minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26(e) and minus the credit for dividends received provided in section 26(b) (computed by limiting such credit to 85 per centum of the net income reduced by the credit for income subject to the tax imposed by Subchapter E of Chapter 2 in lieu of 85 per centum of the adjusted net income so reduced), and minus, in the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26(h). For the purposes of this subsection dividends received on the preferred stock of a public utility shall be disregarded in computing the credit for dividends received provided in section 26(b)."

(As amended by Section 105 (b) of the Revenue Act of 1942, *supra.*)

* * * * *

NOTE: Code Sections can be found in Volume 26 U.S.C., 1952 ed., at corresponding section numbers.

"SEC. 21. NET INCOME.

"(a) DEFINITION.—'Net income' means the gross income computed under section 22, less the deductions allowed by section 23.

* * * * * *

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

* * * * * *

"(c) TAXES GENERALLY.—

"(1) ALLOWANCE IN GENERAL.—Taxes paid or accrued within the taxable year, except—

* * * * * *

"(B) war-profits and excess-profits taxes imposed by Title II of the Revenue Act of 1917, Title III of the Revenue Act of 1918, Title III of the Revenue Act of 1921, section 216 of the National Industrial Recovery Act, or section 702 of the Revenue Act of 1934, or Subchapter E of Chapter 2, or by any such provisions as amended or supplemented;

(As amended by Section 105 (c) (1) of the Revenue Act of 1942, *supra.*)

* * * * * *

"(s) NET OPERATING LOSS DEDUCTION.—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

* * * * * *

"SEC. 26. CREDITS OF CORPORATIONS.

* * * * * *

"(c) Net Operating Loss of Preceding Year.—

"(1) Amount of Credit.—The amount of net operating loss (as defined in paragraph (2)) of the corporation for the preceding taxable year (if beginning after December 31, 1937) but not in excess of (A) the section 102 net income for the taxable year, in the case of the tax imposed by section 102; (B) the Supplement P net income for the taxable year, in the case of the computations required under Supplement P; or (C) the Sub-

chapter A net income for the taxable year, in the case of the tax imposed under Subchapter A.

"(2) Definition.—As used in this section the term 'net operating loss' means the excess of the deductions allowed by this chapter over the gross income, with the following exceptions and limitations—

"(A) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under Section 114 (b) (2), (3), or (4);

"(B) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations.

"(C) For the purposes of this paragraph, the net operating loss deduction provided in section 122 shall not be allowed.

In the case of a taxable year beginning after December 31, 1937, and before January 1, 1939, the term 'net operating loss' means net operating loss as defined in section 26 (c) of the Revenue Act of 1938, 52 Stat. 467."

(As amended by Section 132 (a) of the Revenue Act of 1942, *supra.*)

* * * * * *

"(e) Income Subject to Excess-Profits Tax.—In the case of any corporation subject to the tax imposed by Subchapter E of Chapter 2, an amount equal to its adjusted excess-profits net income (as defined in section 710 (b)). In the case of any corporation computing such tax under section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), section 731 (relating to corporations engaged in mining strategic minerals), or section 736 (b) (relating to corporations with income from long-term contracts), the credit shall be the amount of which the tax imposed by such subchapter is 95 per centum. For the purpose of the preceding sentence the

term 'tax imposed by Subchapter E of Chapter 2' means the tax computed without regard to the limitation provided in section 710 (a) (1) (B) (the 80 per centum limitation), without regard to the credit provided in section 729 (c) and (d) for foreign taxes paid, and without regard to the adjustments provided in section 734. This subsection shall not apply to any corporation exempt from such tax under section 725 or section 727."

(Code section 26 (e) was added by Section 105 (d) of the Revenue Act of 1942; it was repealed by Sec. 122 (g) (1), 1945 Act, effective for taxable years beginning after December 31, 1945)

"SEC. 41. GENERAL RULE.

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

"For use of inventories, see section 22 (c)."

"SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

"The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the

death of the taxpayer shall not be allowed in computing net income for the period in which falls the date of the taxpayer's death."

(As amended by Section 134 (b) of the Revenue Act of 1942, *supra*.)

* * * * * *

"SEC. 48. DEFINITIONS.

"When used in this chapter—

* * * * * *

"(c) 'PAID OR INCURRED', 'PAID OR ACCRUED'.—The terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part."

* * * * * *

"SECTION 56. PAYMENT OF TAX.

"(a) TIME OF PAYMENT.—The total amount of tax imposed by this chapter shall be paid on the fifteenth day of March following the close of the calendar year, or, if the return should be made on the basis of a fiscal year, then on the fifteenth day of the third month following the close of the fiscal year."

"(b) INSTALLMENT PAYMENTS.—Except in the case of an individual (other than an estate or trust and other than a nonresident alien with respect to whose wages, as defined in Section 1621 (a), withholding under Subchapter D of Chapter 9 is not made applicable), the taxpayer may elect to pay the tax in four equal installments, in which case the first installment shall be paid on the date prescribed for the payment of the tax by the taxpayer, the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth monh, after such date. If any installment is not paid on or before the date fixed for its payment, the whole amount of the tax unpaid shall be paid upon notice and demand from the collector."

* * * * * *

(As amended by Section 5 (d) of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126.)

"SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

* * * * * *

"(d) DEFINITIONS.—As used in this chapter—

"(1) SECTION 102 NET INCOME.—The term 'section 102 net income' means the net income, computed without the benefit of the capital loss carry-over provided in section 117(e) from a taxable year which begins after December 31, 1940, and computed without the net operating loss deduction provided in section 23 (s), minus the sum of—

"(A) Taxes.—Federal income, war-profits, and excess-profits taxes (other than the tax imposed by Subchapter E of Chapter 2 for a taxable year beginning after December 31, 1940), paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

* * * * * *

. (As amended by Section 138 of the Revenue Act of 1942, *supra.*)

"(D) Income subject to excess profits tax.—The credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e)."

(As amended by Sec. 105 (e) (2) of the Revenue Act of 1942, *supra.*)

"SEC. 122. NET OPERATING LOSS DEDUCTION.

"(a) DEFINITION OF NET OPERATING LOSS.—As used in this section, the term 'net operating loss' means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(As amended by Section 105 (e) (3) (A) of the Revenue Act of 1942, *supra.*)

"(b) AMOUNT OF CARRY-BACK AND CARRY-OVER.—

"(1) NET OPERATING LOSS CARRY-BACK.—If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each

of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4) and (6), and (B) by determining the net operating loss deduction for such second preceding taxable years without regard to such net operating loss."

(As amended by Section 153 (a) of the Revenue Act of 1942, *supra.*)

* * * * * *

"(c) AMOUNT OF NET OPERATING LOSS DEDUCTION.—The amount of the net operating loss deduction shall be the aggregate of the net operating loss carry-overs and of the net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d), (1), (2), (3), and (4)) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation the normal-tax net income (computed without such deduction and without the credit provided in section 26 (e);

(As amended by Sections 105 (e) (3) (B) and 153 (b) of the Revenue Act of 1942, *supra.*)

"(d) EXCEPTIONS, ADDITIONS, AND LIMITATIONS.—The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

"(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114 (b), (2), (3), or (4);

"(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

"(3) No net operating loss deduction shall be allowed;

"(4) Gains and losses from sales or exchanges of capital assets shall be taken into account without regard to the provisions of section 117(b). As so computed the amount deductible on account of such losses shall not exceed the amount includible on account of such gains.

"(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions and limitations specified in paragraphs (1) to (4) of this subsection.

"(6) There shall be allowed as a deduction the amount of tax imposed by Subchapter E of Chapter 2 paid or accrued within the taxable year, subject to the following rules —

"(A) No reduction in such tax shall be made by reason of the credit for income, war-profits, or excess-profits taxes paid to any foreign country or possession of the United States;

"(B) Such tax shall be computed without regard to the adjustments provided in section 734; and

"(C) Such tax, in the case of a consolidated return for excess-profits tax purposes, shall be allocated to the members of the affiliated group under regulations prescribed by the Commissioner, with the approval of the Secretary.

(As amended by Sections 105 (e) (3) (C) and 150 (e) of the Revenue Act of 1942. Section 304 (e) of the Excess Profit Tax Act of 1950 made Code Sec. 122 (d) (6) inapplicable with respect to any taxable year ending after June 30, 1950.)

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"SEC. 271. DEFINITION OF DEFICIENCY.

"(a) IN GENERAL.—As used in this chapter in respect of a tax imposed by this chapter, 'deficiency' means the amount by which the tax imposed by this chapter exceeds the excess of—

"(1) The sum of (A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over—

"(2) the amount of rebates, as defined in subsection (b) (2), made."

(As amended by Section 14 (a) of the Individual Income Tax Act of 1944.)

"SEC. 336. SUPPLEMENT P NET INCOME.

"For the purposes of this chapter the term 'Supplement P net income' means the net income with the following adjustments:

"(a) ADDITIONAL DEDUCTIONS.—There shall be allowed as deductions—

"(1) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section 500, or a section of a prior income-tax law corresponding to either of such sections.

• • • • • •

(As amended by section 3 (b) of Public Law 378, 81st Congress.)

"SEC. 505. SUBCHAPTER A NET INCOME.

"For the purposes of this subchapter the term 'Subchapter A Net Income' means the net income with the following adjustments:

"(a) ADDITIONAL DEDUCTIONS.—There shall be allowed as deductions.—

"(1) Federal income, war-profits, and excess-profits

extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section 500, or a section of a prior income-tax law corresponding to either of such sections.

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"SEC. 507. MEANING OF TERMS USED.

"(a) GENERAL RULE.—The terms used in this subchapter shall have the same meaning as when used in chapter 1.

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"SEC. 710. IMPOSITION OF TAX.

[As added by Sec. 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974.]

"(a) Imposition.—

(As amended by Sec. 201 of the Revenue Act of 1941.)

"(1) General Rule.—There shall be levied, collected and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

(As amended by Sec. 202 of the Revenue Act of 1942.)

"(A) 95 per centum of the adjusted excess profits net income, or

(As amended by Sec. 202 (a) of the Revenue Act of 1943, c. 63, 58 Stat. 21.)

"(B) an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) equals 80 per centum of the corporation surtax net income, computed under section 15 or Supplement G, as the case may be, but without regard to the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter), and without regard to 80 per centum of the credit provided in section 26 (h) (relating to credit for dividends paid on certain preferred stock.

(As amended by Sec. 202 (b) of the Revenue Act of 1943.)

• • • • • •

"(b) Definition of Adjusted Excess Profits Net Income. As used in this section, the term 'adjusted excess profits net income' in the case of any taxable year means the excess profits net income (as defined in section 711) minus the sum of:

"(1) Specific exemption.—A specific exemption of $10,000, * * *

(As amended by Sec. 204 of the Revenue Act of 1943.)

"(2) Excess profits credit.—The amount of the excess profits credit allowed under section 712; and

"(3) Unused excess profits credit.—The amount of the unused excess profits credit adjustment for the taxable year, computed in accordance with subsection (c).

(As amended by Sec. 2 (a) of the Excess-Profits Tax Amendments of 1941, c. 10, 55 Stat. 17 and Sec. 204 (a) of the Revenue Act of 1942.)

"SEC. 711. EXCESS PROFITS NET INCOME.

(As added by Sec. 201 of the Second Revenue Act of 1940.)

"(a) Taxable Years Beginning After December 31, 1939.—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13 (a) (2), for such year except that the following adjustments shall be as follows:

"(1) Excess profits credit computed under income credit.—If the excess profits credit is computed under section 713 the adjustments shall be as follows:

"(A) INCOME SUBJECT TO EXCESS PROFITS TAX.—In computing such normal-tax net income the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter) shall not be allowed;

(As amended by Sec. 206 (a) (1) of the Revenue Act of 1942.)

* * * * * * *

"(J) Net Operating Loss Deduction Adjustment.—The net operating loss deduction shall be adjusted as follows:

"(i) In computing the net operating loss for any taxable year under section 122 (a) and the net income

for any taxable year under section 122 (b), no deduction shall be allowed for any excess profits tax imposed by this subchapter, and, if the excess profits credit for such taxable year was computed under section 714, the deduction for interest shall be reduced by the amount of any reduction under paragraph (2) (B) for such taxable year; * * *

"(ii) In lieu of the reduction provided in section 122 (c) such reduction shall be in the amount by which the excess profits net income computed with the exceptions and limitations specified in section 122 (d) (1), (2), (3), and (4) and computed without regard to subparagraph (B), without regard to any credit for dividends received, and without regard to any credit for interest received provided in section 26 (a) exceeds the excess profits net income (computed without the net operating loss deduction).

(As amended by Sec. 210 (a) of the Revenue Act of 1942.)

"(2) Excess profits credit computed under invested capital credit.—If the excess profits credit is computed under section 714, the adjustments shall be as follows:

* * * * * *

"(L) Net Operating Loss Deduction Adjustment.—The net operating loss deduction shall be adjusted as follows:

"(i) In computing the net operating loss for any taxable year under section 122 (a), and the net income for any taxable year under section 122 (b), no deduction shall be allowed for any excess profits tax imposed by this subchapter, and, if the excess profits credit for such taxable year was computed under section 714, the deduction for interest shall be reduced by the amount of any reduction under subparagraph (B) of this paragraph for such taxable year; and

"(ii) In lieu of the reduction provided in section 122 (c), such reduction shall be in the amount by which the excess profits net income computed with the exceptions and limitations provided in section 122 (d) (1), (2), (3), and (4) and computed without regard to subparagraph (D), without regard to any credit for dividends received, and without regard to

any credit for interest received provided in section 26 (a) exceeds the excess profits net income (computed without the net operating loss deduction).

(As amended by Sec. 210 (b) of the Revenue Act of 1942.)

PRIOR INTERNAL REVENUE CODE PROVISIONS

"SEC. 23 (c). TAXES GENERALLY.—Taxes paid or accrued within the taxable year, except—

"(1) Federal income, war-profits, and excess-profits taxes (other than the excess-profits tax imposed by section 106 of the Revenue Act of 1935 (49 Stat. 1019), or by section 602 of the Revenue Act of 1938 (52 Stat. 567), and other than the declared value excess-profits tax imposed by section 600);"

(As amended by Section 506 (b) of the Second Revenue Act of 1940, c. 757, 54 Stat. 974.)

REVENUE ACT OF 1937 [c. 815, 50 Stat. 813]

"TITLE IA—ADDITIONAL INCOME TAXES

"SEC. 356. ADJUSTED NET INCOME.

"For the purposes of this title the term 'adjusted net income' means the net income with the following adjustments:

"(a) Additional Deductions.—There shall be allowed as deductions—

"(1) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent now allowed as a deduction under section 23; but not including the tax imposed by section 102, section 351 (either before or after its amendment by the Revenue Act of 1937), or a section of a prior income tax law corresponding to either of such sections.

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"SEC. 357. MEANING OF TERMS USED.

"The terms used in this title shall have the same meaning as when used in Title I."

"TITLE II—FOREIGN PERSONAL HOLDING COMPANIES

"SEC. 336. SUPPLEMENT P NET INCOME.

"For the purposes of this title the term 'Supplement P net income' means the net income with the following adjustments:

"(a) Additional Deductions.—There shall be allowed as deductions—

"(1) Federal income, war-profits, and excess profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section 351 (either before or after its amendment by the Revenue Act of 1937), or a section of a prior income-tax law corresponding to either of such sections."

* * * * * *